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Banks and Derivatives Markets: A Challenge for Financial Policy

A prominent feature of the modern financial landscape is the extensive use of derivative instruments. *International Capital Markets, Part II*, an IMF study published in August 1993, looks into the "explosive" growth in the use of these instruments and the reasons why regulators are concerned about the potential risks for financial systems associated with the heavy involvement of banks in these markets.

The benefits offered by derivative instruments are by now well appreciated. They can be used to change the risk characteristics of securities—for example, their currency denomination or interest rate structure—enabling investors to pursue the most advantageous investment or borrowing opportunities or to hedge positions. In essence, according to the study, "the new instruments and techniques permit the separation and unbundling of risk, the pricing of its separate components (credit risk, liquidity risk, market risk), and the redistribution of risk to those best able to manage it."

But although derivatives can be used effectively to reduce the risk borne by individual agents, they cannot reduce the overall risk in the system. Derivatives only transform and reallocate risk, and some regulators worry that market participants do not understand how this process works. In particular, there is concern that risk has become concentrated in the major commercial banks, which have emerged as the dominant participants in some derivatives markets; as a result, the overall risk to the financial system may have been increased.

On the floor of the London stock exchange. Growth in derivatives markets has been explosive.

Banks and the Markets for Derivatives

An indication of just how fast these markets have grown is the increase in the notional value—the underlying principal value used to calculate the cash flows resulting from derivatives contracts—of outstanding exchange-traded and over-the-counter (OTC) contracts. The notional value quintupled to about $8 trillion at the end of 1991 from an estimated $1.6 trillion in 1987. In terms of U.S. GDP, this increase would represent a jump from about 35 percent to 140 percent. Of the total, OTC instruments—the fastest-growing component—accounted for a little more than one half ($4.4 trillion), followed by exchange-traded contracts ($3.5 trillion).

Interest rate swaps are the most important OTC instrument; at the

Strong Policies Key for Transforming Economies, Says Camdessus

Speaking at a seminar organized by the European Institute, IMF Managing Director Michel Camdessus offered advice, based on the IMF's experience, to economies in transition. External assistance, he said, is an esssential complement to, but not a substitute for, good domestic policies. "What we have learned and what has been confirmed for us go to the basics of our activities at the IMF." See page 52 for excerpts.

end of 1991 the notional principal value of these contracts was almost $3.1 trillion. The market for currency swaps, including cross-currency interest rate swaps, had a notional value of $807 billion. The most important exchange-traded financial derivatives are interest rate futures; global trading volume in these instruments reached 234.5 million contracts in 1991.

It is natural, desirable even, that banks should use derivatives to manage the risks they incur in their ordinary on-balance-sheet activities. But banks have also been drawn to these markets by the income they can generate by acting as dealers in the OTC markets and by providing a wider range of risk management services to their clients. Their activities in these markets have expanded to the point that a handful of large banks in the United States, Japan, France, the United Kingdom, Germany, and Switzerland are now major intermediaries in the OTC derivatives markets. In the United States, for example, between 98 percent and 100 percent of the notional value of all derivatives positions taken by U.S. bank holding companies—about $5.2 trillion in June 1992—is concentrated in only a few large banks.

Derivatives and Risk Management

Banks are exposed to essentially the same kinds of risk in derivatives markets—credit, market, liquidity, and legal risk—as they are in carrying out their other activities.

Credit risk derives from the extension of credit to counterparties who may be unwilling or unable to fulfill their contractual obligations. Credit risk is measured by the cost, at current market prices, of replacing the contract's cash flows if the original counterparty defaults. This cost is generally much less than the notional value of the contract. For example, in September 1992 the 10 U.S. banks most active in the derivatives markets had an aggregate credit exposure of $170 billion, or 17.3 percent of their combined assets.

The design of markets for exchange-traded derivatives actually makes it easier to evaluate and manage credit risk. Credit exposures can be easily monitored, because there is a nearly continuous market for the contracts, and positions must be marked to market at the end of each trading session. More important, the exchange itself—backed by performance bonds, maintenance margins, and bank lines of credit that protect it against default by investors or trading firms—is the counterparty to each transaction, rather than individual traders.

A handful of large banks are now major intermediaries in derivatives markets.

In contrast, the measurement of credit risk in OTC contracts, especially longer-dated ones, can be complicated. The absence of a market for these contracts means that it is more difficult to determine capital gains and losses on a continuous basis.

Credit risk is generally managed by establishing exposure limits for each counterparty, with riskier counterparties facing a wider bid-ask spread. Risk-based spreads are not universal, however; their use is partly limited by the lack of reliable information about the financial positions of counterparties, especially other dealers with complex derivatives books through which banks can become indirectly exposed to defaults by third parties.

In an attempt to reduce these kinds of risks, some banks have recently begun to mark OTC contracts to market where possible and to require periodic margin payments. Consideration has also been given to establishing clearinghouses for OTC transactions.

For firms with many contracts outstanding between them, the net exposure of one firm to another can often be much smaller than the gross exposure. Therefore, if the legal exposure of each firm can be limited to its net exposure, credit risk can be greatly reduced. In the absence of legally enforceable netting, a firm's losses in the event of a counterparty's default would be closer to its gross exposure. The receiver of a bankrupt counterparty might be able to demand payment on all contracts with positive value, while at least temporarily withholding payment on contracts with negative value.

Market risk refers to the effect of changes in the price of the underlying instrument on the value of an open derivative position. Since the source of risk is not firm-specific, market risk is usually managed on a portfolio basis. To some extent, offsetting exposures with different counterparties and diversification across sources of risk can lessen the market risk of a dealer's portfolio. Market risk management will thus involve calculating the net exposure of the portfolio and hedging this risk in the spot or derivatives markets. These hedging operations can raise credit risk, however, because they involve taking new positions rather than unwinding existing ones.

Liquidity risk—the risk that a transaction cannot be arranged at the prevailing market price—is the most difficult to manage. The markets for OTC instruments, which often are tailor-made for particular clients, are less liquid than the markets for the more homo-

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geneous exchange-traded products. Dealers with uncovered OTC positions will try to cover them either by taking offsetting positions in an exchange-traded product or by synthesizing such a position through dynamic hedging. However, dynamic hedging can actually exacerbate illiquidity because it often mandates either the sale of an underlying security when its price falls or its purchase when the price rises. These mandated transactions can trigger an avalanche of purchase or sale orders into a relatively illiquid market for the underlying security. Moreover, in times of uncertainty, markets for key underlying assets can become illiquid, making it difficult to reposition the hedge portfolio. The resulting illiquidity may even violate the assumptions underlying the models used to construct these portfolios at precisely the time when the hedges are most needed.

Systemic Risk and Public Policy

Regulators in many countries have become increasingly concerned about the risk of a systemic disturbance arising from the derivatives markets, particularly the OTC markets. Central to this concern is the belief that the implicit guarantee of banks' obligations provided by the official safety net has unintentionally subsidized the OTC markets. This implicit guarantee has made possible the extraordinary expansion of these markets and has exposed the financial system to greater risk.

Regulators are concerned that senior managers of banks and investment firms, as well as the regulators themselves, may not have a complete understanding of some of these products. As a result, the risk management systems that they have put in place may not be appropriate.

Also, derivative instruments tend to strengthen linkages between market segments and between individual financial institutions in ways that are difficult to identify or quantify. Consequently, disruptions or increased uncertainty in one market may now be more likely to spill over into other derivatives markets and into the cash markets.

Finally, regulators are concerned that risk in the OTC market is overly concentrated in the hands of a few major market players, that this risk is systematically underpriced, and that the financial safety net would have to be expanded beyond the banking system to cover nonbank financial intermediaries.

Could systemic risk be reduced if more OTC business were channeled to the organized exchanges?

Limiting Systemic Risk

Efforts at limiting systemic risk have so far centered on strengthening individual institutions through various means:

- improved risk management practices;
- enhanced oversight of off-balance-sheet activities by management and regulators; and
- improved payment and settlement systems through the development of arrangements for netting OTC derivative contracts.

The Group of Ten's Basle Committee on Banking Supervision has been making major efforts to revamp regulatory and supervisory frameworks to allow banks to cope with the new, more competitive international environment. The Basle Accord allowed for the inclusion of banks' off-balance-sheet positions in their risk-adjusted capital requirements by defining credit equivalent measures of OTC interest rate and currency exposures. The Accord recognized netting, but only if it involved folding the accumulated net position into a new legally binding contract (netting by novation).

The study notes that revisions to the Accord proposed in April 1993 would expand the recognition of netting by allowing banks to apply capital requirements to net open positions wherever such arrangements were legally enforceable. Other proposed changes include capital charges for interest rate risk and the monitoring of other sources of market risk.

The IMF study asks whether systemic risk could be reduced if more of the OTC business were channeled to the organized exchanges, where margin requirements and loss-sharing arrangements have gone a long way toward eliminating credit risk. Although this action would certainly have no harmful effects, some of the better-capitalized banks may be just as creditworthy as some clearinghouses. In addition, since clearinghouses and exchange members rely on bank lines of credit, the ultimate protection from liquidity risk is the same in both markets. ■

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International Capital Markets, Part II: Systemic Issues in International Finance, which was prepared by an IMF staff team led by Morris Goldstein and David Folkerts-Landau, is part of the IMF's World Economic and Financial Surveys series. Copies are available for $20 each ($12 for full-time university faculty and students) from Publication Services, Box S-392, International Monetary Fund, Washington, D.C. 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

For Economies in Transition, Strong Policies Attract External Assistance

Following are excerpts of an address delivered on February 14 by IMF Managing Director Michel Camdessus at a seminar on "Implications of Western Policies for the Economic Recovery in Eastern and Central Europe," which was held at the IMF and organized by the European Institute:

You are discussing some of the most momentous challenges of our time—the transformation of the economies of Central and Eastern Europe and their integration into the global economy. Let me contribute modestly by telling you what we, at the IMF, have learned from the early history of this process, and also by indicating what remains to be done, especially now in Russia, where many of our concerns are focused. What we have learned and what has been confirmed for us go to the basics of our activities at the IMF: policies and financing.

First, it is the policies of the countries that provide the key to their success. The transition to a market economy entails inescapable challenges for policy—prices have to be freed; the economy has to be opened to the rest of the world; macroeconomic stability has to be established; laws and institutions have to be reformed; enterprises have to be commercialized and privatized; and the poor and vulnerable have to be protected.

What challenges these are! But where they have been faced with determination and consistency, observe the results:

- In Poland, growth in 1993 was the second fastest in Europe, and similar growth is expected this year. Inflation, at more than 30 percent a year, is still certainly too high; but it has been brought down from an average monthly rate of 18 percent in 1989. The transition in Poland is not complete, and indeed important challenges are currently being faced. But we can say, four years after the transformation began, that a growing market economy has been established.
- In the Czech Republic, we see another emerging success story. Important structural reforms still lie ahead, but inflation has been reduced almost to single digits at an annual rate, and growth is resuming. This country was even able to stop borrowing from the IMF during 1993 and has, in fact, been receiving large private capital inflows.
- Albania, whose situation less than two years ago seemed especially dire, was in 1993 the fastest growing economy in Europe by far, with a growth rate close to 10 percent; and its inflation was similar to that of Poland. Its recovery is expected to continue this year. Who would have expected that in 1991?

In the countries of the former Soviet Union, the transition began later than in Central Europe, the initial macroeconomic imbalances and distortions were worse, and more institution building needed to be done. But it has been shown that these obstacles are not insuperable. Observe the progress made in Estonia, Latvia, and Lithuania. In each of these three Baltic states, inflation is being brought decisively under control. Output turned up during 1993, and continued recovery is expected this year.

The progress made by these countries in Central Europe and the Baltics has not been fortuitous. Nor—and I emphasize this—can it be attributed mainly to external assistance. In each case, what underlies it is the resolute implementation of comprehensive and rigorous policies of macroeconomic stabilization and structural reform.

Just as strong policy programs have achieved progress in the countries I have mentioned, the attempt in some other countries—including, I regret to say, Russia and Ukraine—to protect existing patterns of output and employment through subsidies and credits has not brought stabilization or growth. This so-called more gradualist approach has instead prolonged the transition and made it more painful.

It is clear what the countries that have not yet been successful need to do to establish the conditions for sustained growth: they need to strengthen their stabilization efforts and speed up their reforms. To those who say that the IMF is advocating shock therapy, I would ask: who will have suffered the more severe and prolonged shocks—the peoples of Poland, the Czech Republic, and the Baltics, where growth has resumed and inflation is being brought under control, or the people of those countries where lack of discipline and gradualism have brought hyperinflation or the threat of it?

There is no shock more cruel than prolonged recession, hyperinflation, and economic disorder. In fact, if there are shocks anywhere, they are there, and in the legacy that the countries in transition have inherited, not in the policy strategies supported by the IMF.

Let me say a special word about Russia. A great deal has been accomplished by the Russian authorities in the past two years—notably in the liberalization of prices and the exchange rate system, the setting of key interest rates close to positive real levels, and substantial progress with privatization. The private sector has begun to respond to these important measures. But as a result of a lack of consistent fiscal and monetary discipline, inflation has remained far too high, and has indeed risen again recently, to around 20 percent in January.

Such rapid inflation undermines the working—indeed, the virtue—of a market economy. It deters foreign and domestic

investment, promotes capital flight, and undermines reform and the transition process itself. And it hurts the poor most.

Most other countries of the former Soviet Union face similar tasks, and in all of them the historic challenge facing the leadership is to build the consensus required to sustain policies of the kind that have been shown to provide the key to success.

Leszek Balcerowicz of the World Bank; IMF Managing Director Michel Camdessus; Jacqueline Grapin, European Institute President; and Bela Kadar, Hungarian Minister for International Economic Relations, at the seminar.

But the transition process in the countries of Central and Eastern Europe also presents the rest of the world with a challenge, and this brings me to the second of my two basic points: *external assistance and cooperation for the economies in transition are essential, but they should be seen as complementary to, not substitutes for, good domestic policies.*

The countries in transition need and deserve assistance from the rest of the world in a variety of forms. First, access to markets: at a time when they are endeavoring to establish viable economies, it is essential that these countries be allowed to compete in markets where they have a comparative advantage. Another field of cooperative action is technical assistance, an essential vehicle by which the international institutions, governments, private organizations, and particularly private enterprises can facilitate these countries' transformation efforts, and indeed lay the groundwork for fruitful cooperation in the future.

There is also, of course, financial assistance. Let me tell you here that contrary to what has recently been said by some—with more eloquence than respect for truth—the money made available by the so-called West in support of Russia has not been so negligible! It amounted to at least $58 billion over the two years 1992–93.

But the IMF, in particular, has been criticized for not disbursing enough. As far as the IMF is concerned, the financial assistance it can provide is necessarily tied to countries' policies. This is part of the rules by which the IMF is governed—rules agreed by the entire membership, but sometimes forgotten in the capitals. The conditionality of the IMF's lending is designed to ensure the restoration of equilibrium and growth in its member countries.

The IMF has been actively providing financial support for programs of stabilization and reform in the countries of Central and Eastern Europe, and we are hoping soon to enter into new arrangements with Bulgaria and Romania to help put their programs back on track. In the countries of the former Soviet Union, the IMF has provided financial support for programs not only in the three Baltic republics but also in Belarus, Kazakhstan, the Kyrgyz Republic, Moldova, and, of course, Russia.

The IMF has provided financial assistance to Russia twice, in 1992 and 1993—last year, using our new systemic transformation facility (STF), which was introduced specially to assist the economies in transition in dealing with the disruptions caused by the shift to multilateral, market-based trade. On both occasions, important policy undertakings in crucial fiscal and monetary areas were not fully implemented, with the result that inflation was not brought under effective control.

We are now again actively discussing with the Russian authorities the policies needed to promote stabilization and reform, and we fervently hope to reach agreement on a program that the IMF could support with the disbursement of the second tranche of the STF and, subsequently, with a stand-by arrangement. But this will depend on the Russian authorities' ability to commit themselves to, and to start implementing, credible policies to speed up the stabilization and reform process.

But the complementarity between policies and financing goes much further than IMF conditionality or the IMF's catalytic role. To see how the international community responds to strong and sustained policies of adjustment and reform, consider the recent experience of Latin America, where a number of countries that were at the center of the debt crisis a decade ago have been receiving large private capital inflows.

Therefore, the financing available to the economies in transition is very much a function of the strength of their policy programs. If we seem to insist ad nauseam on these very basic observations it is because we believe that they are essential, particularly in a case such as Russia where there is so much at stake, for a great people and for the prosperity of the world—so much at stake that we cannot take the risk of making a wrong decision through impatience or misguided good intentions.

Success is achievable, I am convinced. It is mainly dependent on the countries in transition themselves: it is mainly their job. But they cannot do it alone. Success must be promoted by the assistance and cooperation of the international community, including timely financial support once good policies are in place. ■

Financial Relations Among States of Former Soviet Union Undergo Change

The breakup of the U.S.S.R. in late 1991 threw the financial relations among the states of the former Soviet Union into disarray. According to a soon-to-be-published IMF Economic Review, during most of 1992–93, financial relations among these states were characterized by a poorly functioning payments mechanism, unstable monetary arrangements, and chronic balance of payments deficits with Russia.

These problems, according to the study, entitled *Financial Relations Among Countries of the Former Soviet Union*, called for actions that would include:

- improving the interstate payments system, thereby removing an important impediment to trade;
- reducing uncertainty about currency arrangements in the countries in the region and creating preconditions for achieving domestic monetary control; and
- addressing the large balance of payments deficits between many of the states and Russia.

Reforming the Payments Mechanism

The payments system that the states of the former Soviet Union inherited from the U.S.S.R. had been designed for a centrally planned economy. As such, it imposed no market discipline and was, according to the authors, ill-suited to handle payments between increasingly market-oriented enterprises.

In their attempts to reform the payments mechanism, the authorities have pursued the following three objectives:

Improvements in Central Bank Settlements. Under the old system, the State Bank of the U.S.S.R. (Gosbank) provided automatic overdrafts on the reserve balances of other banks. In early 1992, a set of bilateral correspondent accounts was set up between the central banks of the newly independent states. The central banks were not supposed to make payments through these accounts without funding, but large imbalances arose, and in mid-1992, the Central Bank of Russia imposed limits on this type of financing. In the third quarter of 1993, this financing function was transferred to the budget.

Decentralization of Cross-Border Settlements. During 1992 and 1993, the authorities of many states of the former Soviet Union permitted commercial banks to establish cross-border correspondent accounts with one another. Although decentralization was expected to speed up payments and reduce financing difficulties of deficit states, there have actually been net capital inflows from banks in other states to Russian commercial banks. According to the authors, payments decentralization can only help reduce net financing difficulties if it is accompanied in the other states by macroeconomic stabilization, liberalized interest rates, currency convertibility, and a coordinated supervisory and regulatory framework containing counterparty risk.

Setting Up of Foreign Exchange Markets. The recent proliferation of new currencies among the states of the former Soviet Union has made development of foreign exchange markets a necessary feature in decentralizing interstate payments. The currency conversion in Russia, which took place in July 1993, also made it necessary for countries to choose a means of establishing their exchange rates.

Pending further decentralization of payments and the attainment of currency convertibility by most of the countries, the Interstate Bank, which was constituted in December 1993, could serve a useful transitional purpose of facilitating the processing of interstate payments and reducing the inefficiencies of the bilateral payments arrangements. The Interstate Bank is expected to improve the predictability and security of payments by "executing a fully automatic, nondiscretionary settlement procedure." As a supranational institution, the Bank will be insulated from pressures for financing to which other regional central banks have been subject.

The Interstate Bank is intended to operate as a multilateral clearing mechanism and not as a payments union empowered to extend credit. The ability to run up external imbalances within a payments union might encourage insularity: member states might be inclined to concentrate on expanding mutual trade at the expense of commerce with other countries at world market prices. It could also act as a disincentive for the pursuit of stabilization policies and delay convertibility of their currencies.

Reforming Monetary Arrangements

Following the dissolution of the U.S.S.R., the 15 successor states attempted to coordinate monetary policy within the existing ruble area. This attempt proved futile, however, and by the end of 1993, all of the countries in the region, except Tajikistan, had introduced their own currencies.

According to the authors, two changes in Russian financial policy led

to the dissolution of the ruble area:

• In July 1992, the Central Bank of Russia introduced limits on interstate credit. These led to the creation of de facto separate deposit monies in states with differing balance of payments disequilibria.

• At the end of July, the Central Bank of Russia demonetized pre-1993 banknotes in Russia, which effectively deprived the ruble area of its common cash currency. Attempts among some countries in the region to establish a new ruble area with Russia failed, and all of them except Tajikistan then assumed control of their own monetary regimes. (In early 1994, however, discussions continued between Belarus and Russia on a possible monetary union.)

Although the old ruble area has disappeared, the authorities in most of the states of the former Soviet Union continue to discuss "a common economic space" to facilitate trade in the region. On September 24, 1993, nine states signed a framework treaty for comprehensive economic union. The treaty provides for a "gradual deepening of integration" through the progressive establishment of a free trade zone, a customs union, and a common market, as well as monetary and fiscal coordination. Discussions among the potential members are continuing, but no timetable has been established for implementation.

Evolution of Financial Relations

The states of the former Soviet Union inherited a highly distorted system of trading relationships characterized by large imbalances. The imbalances were financed through automatic transfers through the branches of Gosbank.

The distortions arose primarily because prices for energy and raw materials were maintained at below world-market levels. Because Russia was a major net exporter of these products, it provided a sizable and implicit subsidy to most of the other union republics. Based on the real exchange rate for Russia for mid-1993, this subsidy would have amounted to about 15–20 percent of Russia's GDP in 1987.

Resource flows to the newly independent states did not dry up following the dissolution of the Soviet Union, although the breakup did subject their economies to large internal and external shocks. Net importers of raw materials and energy were hit with hefty terms of trade shocks as their interstate prices began to rise relative to those for other traded goods. Independence also spelled the end of fiscal transfers from the union budget of the former Soviet Union.

Developments in 1992. Rising prices on imports resulted in large contractions in import volumes among the net importers, which contributed to a large contraction in output in most states. But the effects of the terms of trade shock were partially accommodated through substantial financial transfers from Russia.

The financing that Russia provided to the other countries in the region (excluding the Baltic states) was equal to about 20 percent of these countries' combined GDP, and, in some cases, it was substantially higher. Russia also continued to extend large implicit trade subsidies to the other states.

Developments in 1993. Official flows to the states of the former Soviet Union from Russia slowed substantially in 1993, and central bank financing was replaced, in some cases, by other arrangements. In contrast, net flows from the other states to Russian commercial banks continued.

In 1993, Russia replaced central bank financing with intergovernmental credits to the other states of the former Soviet Union (except the Baltic countries). A condition for agreement was that existing central bank imbalances would have to be refinanced as interest-bearing state debt indexed to the U.S. dollar or the SDR. Russia signed agreements with 10 other states; these provided for the consolidation of existing Central Bank of Russia claims on the central banks of these countries and for commitments on new intergovernmental credits for the rest of 1993.

Vendors at the Central Market in Minsk, Belarus.

Facing the Future

How successfully the states of the former Soviet Union make the transition to market-based economies may depend on how well they can rebound from two shocks that they now face: the further adjustment of interstate energy export prices toward world market levels, and the reduction in official financing provided by Russia.

These shocks will likely have highly negative effects on income and spending in 1994, especially if amplified by inadequate efforts to adjust to the changes in circumstances that have already taken place. (The Baltic states stand out by the extent to which they had already experienced most of the terms of trade shock in 1992 and by the rapid adjustment of trade and output levels that has already taken place.)

The extent to which these shocks negatively affect output and living standards will depend on:

- the initial price for energy imports from other states;
- the initial degree of dependence on energy imports and other critical inputs, and the ability to use these inputs efficiently;
- the speed at which new export markets can be found both in Russia and outside the region; and
- the amount of private and official financing the states can obtain from other sources.

The adjustment burden is likely to be severe, according to the authors. But the need for these countries to adjust fully to the lower terms of trade and the reduced level of financial transfers from Russia is "inescapable." The critical policy challenge now is to ensure that the necessary adjustment is not indefinitely postponed but that it also be as orderly as possible. Orderly and efficient adjustment would be greatly facilitated by a combination of:

- strong macroeconomic policies that provide a stable environment for structural change and encourage official external assistance and foreign direct investment;
- accelerated structural reforms to ensure an expansion of future productive capacity;
- an active financing role by Russia—consistent with its own need for macroeconomic stabilization—to prevent a major further output collapse in neighboring states; and
- more concerted efforts by governments outside the region to provide external assistance. ■

Financial Relations Among Countries of the Former Soviet Union is No. 1 in the IMF's Economic Review Series for 1994. Copies are available for $15.00 each from Publication Services, Box S-389, International Monetary Fund, Washington, D.C. 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

From Central Plan to World Market: Trade Policy Reform in the Former Soviet Union

For all members of the world community, fully functioning trade relationships with the rest of the world are key to stability, growth, and development. For the states of the former Soviet Union, the establishment of such trading relationships will require major overhauls of current trade and trade-related policy and the creation of entirely new policies based on radically different economic premises.

As pointed out in a soon-to-be published IMF study entitled *Trade Policy in the States of the Former Soviet Union*, the rationale for trade liberalization is as applicable to these economies as it is to other members of the global trading community: "an outward-oriented strategy is more likely than an inward-looking one to lead to high and sustainable growth."

The Unique Challenges

Before the dissolution of the former Soviet Union, foreign trade targets were included in the central plan, which allocated resources according to mandatory production and delivery targets. Trade within the Soviet Union through the Council for Mutual Economic Assistance (CMEA) was in the form of annual bilateral clearing arrangements and reflected deliberate central investment and planning decisions. The Soviet Union provided implicit subsidies to CMEA members by offering favorable terms of trade between its exported energy and raw materials and the manufactured goods it imported.

By the end of the 1980s, the distortions and inefficiencies of central planning could no longer be ignored. Even before the breakup of the Soviet Union, a market economy became the declared goal of economic reform. After 1991, the newly independent states saw that opening their economies and integrating them into the world trading system was the ticket to this transition.

The particular features and circumstances of these new nations distinguish them from other countries embarking on trade reform and pose unique problems for the design and implementation of a successful trade policy. According to the IMF review, these include:

- a high degree of specialization in production and trade and a resulting dependence on interstate trade;
- the absence of market-based institutional and legal frameworks and an unusually strong need for fundamental, systemic reform;
- the intricate linkage between achieving macroeconomic stability and successful structural reforms in the wake of terms of trade shocks and trade dislocations brought about by moves toward world market prices; and
- the need to take (as well as to build the political consensus for) a wide

range of radical steps in a number of related areas "virtually simultaneously."

A "Critical Mass" of Reforms

For these new nations, trade liberalization cannot be realized without a fundamental, systemic reform of their basic economic structures. Such a reform, according to the IMF review, would require replacing the institutions of central planning with the laws and institutions on which market economies are grounded, as well as creating an environment that supports and nourishes the growth of an "entrepreneurial culture" that was destroyed by decades of communism. In the area of trade alone, the institutions and instruments that need to be established include customs administrations, border controls, payments systems, trade taxes, and market-oriented exchange rates.

If these institutions are to flourish, they must be supported by a stable economy. But if the economy is to be stabilized, the underlying causes of instability must be rooted out. Destabilizing elements prevalent in many of these economies include:

- insufficiently hard budget constraints on enterprises;
- weak tax bases;

monetary policies characterized by an absence of rules and a lack of coordination among countries within the ruble area; and

- ongoing terms-of-trade shocks associated with the move to market prices for energy and raw materials.

In a fundamentally unstable economy, say the authors, high inflation would obscure the signaling function of relative price changes, and excess demand would put pressure on the balance of payments. These pressures, in turn, could jeopardize the liberalization process or raise doubts about its sustainability.

Although macroeconomic stability is crucial, delaying price and trade liberalization until such stability is established would increase the overall cost of transition: resource allocation would continue to be guided by distorted relative prices, and domestic monopolies would remain unchecked. As a result, the eventual opening up of foreign competition would be met with growing resistance.

Street vendors in Bishkek, the capital of the Kyrgyz Republic.

To ensure that adjustment moves in the right direction, the states of the former Soviet Union need a balanced package of macroeconomic and structural reforms, comprising, according to the authors, a "critical mass" of reforms that would have to be undertaken early on in the transformation. This critical mass would include speedy stabilization, price liberalization, exchange and payments reforms, and commercialization of enterprises ("hard budget constraints"). It would also include adopting a credible and clear medium-term program of further trade liberalization to accompany and reinforce institution building and systemic reforms.

Reform Efforts

The attempt by the Soviet authorities in the late 1980s to introduce some economic reforms had little or no effect on the underlying system, and the trade regime remained biased against exports. In 1990–91, as the central authority began to erode, union republics acquired some autonomy in economic decision making. The speed of reform among the republics differed, however, and regional differences in prices and incomes policies, and lack of confidence in the ruble resulted in arbitrary measures to restrict export flows within the U.S.S.R.

After the dissolution of the U.S.S.R. in late 1991, the differences between the trade systems of the newly independent states increased. The disintegration of the union-wide payments system and the ruble area led to the introduction of explicit export restrictions by most countries and to the collapse of trade between the states of the former Soviet Union.

In 1992 the Baltic states progressed considerably in both building institutions and implementing reforms to support trade liberalization, including monetary independence, exchange reform, and macroeconomic stabilization. In contrast, during 1992 and through mid-1993, the pace of trade reform in the other states of the former Soviet Union was slow and uneven, owing to a lack of consensus over key economic policies and, in some cases, military conflicts.

Lessons from Central and Eastern Euope

The Central and Eastern European economies have been engaged in the transformation process for a few years, and their experience, despite differences in initial circumstances, offers some lessons for the states of the former Soviet Union. It is true that in the early stages of reform, many of the transforming economies in Central and

Eastern Europe—unlike the states of the former Soviet Union—already had some essential institutions in place. These included their own currency and well-established customs and trade procedures. Many of them also had a history of trade with the West and were members of the General Agreement on Tariffs and Trade.

In other respects, however, the Central and Eastern European economies and the states of the former Soviet Union faced similar challenges, including the radical shift from central planning to a market-based system, the enormous task of simultaneously tackling macroeconomic stabilization and major structural reform, and the need to deal with major short-term dislocations in output and employment.Several important lessons have emerged from the experience of the countries of Central and Eastern Europe.

Early Trade Reform. Opening up the economy early in the transformation process by exposing the state-dominated enterprises to import competition and stimulating private sector enterprise can be a spur to restructuring. Early trade reform can also reinforce the credibility of the government's commitment to reform.

Complementary Price and Exchange Reform. The liberalization of domestic prices needs to precede or accompany trade reform, so that relative prices can adjust to changing market conditions and domestic industries can respond to competitive pressures. Likewise, the exchange system needs to be free of multiple exchange rates and other distortions.

Macroeconomic Stabilization. The benefits of structural reforms cannot be realized without macroeconomic stability. Hard budget constraints on enterprises and restrained monetary and fiscal policies must accompany the freeing-up of trade.

Withstanding Protectionist Pressures. In the experience of several reforming economies, as successful stabilization has corrected the initial overdepreciation of exchange rates and other reforms have taken hold, domestic industry has tended to push for protection. Governments have found it difficult to resist these pressures and have responded by raising tariffs or introducing surcharges. The variable and unpredictable tariff structures have probably increased the costs of transition, as well as distortions and uncertainty for producers and investors in the restructuring process.

Access to Western Markets. According to the authors, ready access to Western markets was crucial to the success of reform in the Central and Eastern European economies. All of them have signed Association Agreements with the European Union (EU). Although the EU has continued to impose restrictions on some important exports of these countries, the Association Agreements and other arrangements with Western countries have contributed to the transformation of the reforming economies and helped them to mobilize domestic support for reform efforts and to secure improved and immediate market access in important areas.

Approaches to Trade Reform

The authors note that progress among the states of the former Soviet Union has been "uneven and limited." The experience of the Baltic states indicates that rapid macroeconomic stabilization combined with structural reform, including trade liberalization, is both feasible and fruitful, that political consensus and determination are needed to pursue this course, and that the short-term output effects of rapid reform are not necessarily worse than those of more gradual approaches.

But during 1993, trade regimes in the other states of the former Soviet Union continued to be dominated by centralized and government-directed imports and exports. Exchange restrictions limited competition from abroad; and pervasive quantitative restrictions on "strategic" goods (energy, raw materials, basic consumer goods) aimed at keeping prices below world market levels forced the countries into bilateral trade agreements to ensure sufficient supplies.

Based on a review of existing trade regimes and the lessons learned from the Central and Eastern European experience, the authors suggest a sequenced approach to trade reform for the states of the former Soviet Union:

- Highest priority should be given to eliminating price controls and phasing out the apparatus of quantitative restrictions on exports, state trading, and state orders. These reforms would reestablish the link between domestic and world prices.
- On the import side, eliminating centralized imports and import subsidies, both of which distort relative prices and impede private sector development, are the most important measures. Removal of these subsidies is likely to cause hardships, however, and may have to be accompanied by social safety nets targeted to the vulnerable sections of the population.
- Import tariff policy should be devised within a medium-term framework aimed at a low and relatively uniform tariff that will, according to the authors, "send clear signals at the outset to enterprises that market competition is inevitable."
- As price and exchange liberalization take hold and subsidies are removed, pressures for protection are likely to arise. The temptation to drift into quantitative trade restrictions or highly dispersed tariff structures must be resisted, as must arguments in support of infant industry or temporary protection.

kets, in particular, is crucial. The states of the former Soviet Union still face stiff tariff and nontariff barriers in sectors where they are most competitive. Inadequate market access risks weakening support for reform, which, ultimately, could result in high economic costs to industrial countries.

• Integration into the multilateral trade system should be an important medium-term goal of any trade reform package. To achieve it, unilateral trade liberalization should be vigorously pursued, and not be held back in hopes of gaining reciprocal market access.

The importance of unilateral trade liberalization, according to the authors, cannot be overemphasized. In the experience of other reforming economies, this strategy has proven to be key to long-term sustainable growth. Integration into the global trading community would enhance credibility in a country's reform program and secure greater market access.

• Proposals for economic union among several states of the former Soviet Union are under consideration. In the formulation of preferential arrangements, policymakers should take care not to perpetuate the inefficient resource allocation of the past.

■

Trade Policy Reform in the States of the Former Soviet Union is No. 2 in the IMF's Economic Review Series for 1994. The publication was prepared under the direction of Jack Boorman, Director of the Policy Development and Review Department, and was written by an IMF staff team comprising Naheed Kirmani, Klaus Enders, and Uwe Corsepius. Copies are available for $15.00 each from Publication Services, Box S-388, International Monetary Fund, Washington, D.C. 20431, USA. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

New System of National Accounts Published

The revised *System of National Accounts* (1993 *SNA*) is expected to become the key conceptual framework for national accounts in almost all countries. Published by the IMF, the European Union, the Organization for Economic Cooperation and Development (OECD), the United Nations, and the World Bank, the report is a major advance in national accounting over the previous version, published in 1968. It reflects many of the economic concerns and changes in economic structures that have occurred over the past twenty-five years.

Development of the 1993 *SNA* involved unprecedented cooperation over the last decade by staff from the five organizations and input from experts in more than fifty countries in all stages of economic development. An Intersecretariat Working Group representing the five organizations was formed to oversee the revision. Over a ten-year period, this group organized meetings to incorporate wide-ranging comments on development of the system.

The 1993 *SNA* was unanimously recommended to the United Nations Economic and Social Council by its Statistical Commission in February 1993. The Council, in turn, recommended to member states that they use the *SNA* as the international standard for the compilation of their national accounts statistics, as the basis for integrating related statistics, and for the development of internationally comparable data. Many developed and developing economies have already established timetables for conversion of their existing national accounts to the new *SNA*. It will be the basis of the system that will be used by all members of the European Union; the United States—which has used its own system of National Income and Product Accounts—has also decided to adopt it. The new SNA will be particularly useful for those countries in transition to market-oriented economies to replace their existing systems.

Features of the New *SNA*

The 1993 *SNA* is organized to support many facets of economic analysis and policy formulation. The revised system provides important performance measures—with respect to production, income, consumption, savings, capital formation, and means of financing—of an economy as a whole during a specific period.

The measure of GNP, which had disappeared from the 1968 *SNA*, has been reinstated in the 1993 *SNA*, although it has been renamed Gross National Income to emphasize that it is a measure of income rather than output. The same measures are also developed for major sectors (including government, households, and financial and nonfinancial enterprises) of an economy.

To provide greater detail on the impact of government operations, the 1993 *SNA* also introduces a new measure of actual consumption as well as consumption expenditure for government and households. Many consumption outlays of government do not bring about consumption by the government or by the country collectively but, instead, pay for goods that are transferred in kind to households, which actually consume them. Actual consumption gives a better measure of final consumption and is a better basis for international comparisons.

The box on page 61 illustrates the structure of the accounting framework of the 1993 *SNA* and the major balancing items and other aggregates measured in the system. The SNA contains three sets of accounts:

- current accounts;
- accumulation accounts; and
- balance sheets.

Current accounts measure production and foreign trade in goods and services, the allocation of income, income redistribution, and use of income. In each account there is a balancing item that is carried forward to the next account as a resource. For example, value added is the balancing item of the production account, and it is carried forward to the income accounts as a resource. Similarly, disposable income is the balancing item in the distribution of income account and is a resource in the use of income account; the difference between disposable income and consumption is savings, the final balancing item in the current accounts.

The production process is described in greater detail in the supply and use and input-output tables, which offer a breakdown by industries and goods and services. The supply table shows the goods and services that have become available to the economy by means of imports and domestic production; the use table shows how this supply has been absorbed through exports, inputs in the production process, final consumption, and investment. On the basis of the supply and use tables, analytical input-output tables are developed that serve a wide range of analytical purposes.

Accumulation accounts measure all the transactions and other flows during a period that affect the quantity and value of assets and liabilities. The capital account measures gross fixed capital formation, changes in inventories (stocks), and capital transfers. The 1993 *SNA* also introduces the concept of valuables in the capital account. This includes tangible assets, such as precious metals, paintings, and antiques, that are held primarily as stores of value. The balancing item of the capital account is net lending or borrowing of the economy (or a sector). The financial account indicates how net lending surpluses are allocated or how net borrowing balances are financed through transactions in financial assets and liabilities.

One of the most important features of the 1993 *SNA* is the more thorough treatment of the role of financial instruments, institutions, and markets in the economy. The revaluation account measures changes in the value of assets, liabilities, and net worth owing to changes in the level and structure of prices, which are reflected in holding (or capital) gains and losses. The "other changes in the volume of assets" account records changes attributable to, for example, natural catastrophes, seizures of property, and the discovery and depletion of subsoil assets; these affect the existence and value of assets, but do not involve transactions.

Another major improvement in the 1993 *SNA* is the full integration of the third set of accounts—*balance sheets*—with those for transactions. This permits a detailed analysis of national wealth and the causes of changes in wealth.

SNA Mirrors Policy Developments

The new *SNA* reflects major changes and increased policy concerns in the world economic environment over the past twenty-five years. These include:

- greater concern about inflation, an issue the *SNA* addresses through the development of a separate revaluation account for assets and liabilities;
- the significance of service activities, the characteristics and treatment of which are described in greater detail in the *SNA*;
- changes, in many countries, in government operations that have led to improved measures of consumption and detailed treatment of value-added taxes; and
- substantial innovations in financial instruments, institutions, and markets, changes that the *SNA* addresses by providing revised criteria for defining financial enterprises, a more complete treatment of financial instruments (including derivatives), and a more thorough treatment of financial transactions.

A major effort has also been made to harmonize the new *SNA* with related statistical systems—particularly the balance of payments.

What the New SNA Does Not Do

The 1993 *SNA* is designed to be a flexible tool for the compilation and use of national accounts. It defines rigorously the boundaries of the economy and the major sectors and provides a clear set of accounts to measure transactions and assets and liabilities.

The new *SNA* is not, however, the final word on national accounts. It represents compromises in a number of areas, and reservations have been expressed by some countries on several issues. The new *SNA*, like previous versions, does not measure services produced within households as output. The treatments of research and development expenditure, the rental value of government buildings, subsidies targeted for consumers, and the measurement and allocation of services provided by financial institutions were not resolved to the satisfaction of all countries. The new *SNA*, therefore, recognizes the need for alternative approaches and measures that can

Photo credits: Peter Marlow/Magnum, page 49; Denio Zara and Padraic Hughes for IMF, page 53; Murray Seeger, pages 55 and 57.

be dealt with by extensions of the system or more elaborate satellite accounts.

The 1993 *SNA* does not, within its own framework, resolve all issues, nor does it meet all the specific requirements of policymakers. This is perhaps most clearly the case in the area of environmental statistics. However, the development of satellite accounts allows alternative approaches, such as environmental accounting, to be developed in parallel with national accounts.

Because the new *SNA* does not resolve all conceptual issues in national accounts and related fields of statistics, work organized by the Intersecretariat Working Group on unresolved and new issues will be undertaken on an ongoing basis. The organizations in the Intersecretariat Working Group are also developing programs to assist their member countries in the implementation of the 1993 *SNA*.

The IMF's Role

The IMF has played an active role in the development of the new *SNA*. The two main objectives of the IMF's involvement were improving national accounting in IMF member countries and harmonizing national accounts with the other key statistical systems (including balance of payments, government finance, and monetary and financial statistics) for which the IMF has major responsibility. The IMF will provide assistance in the implementation of the new system through technical assistance and training activities.

Harmonization with other related statistical systems benefits both compilers and users of these data. In September 1993, the IMF published the fifth edition of the *Balance of Payments Manual*. One of the major achievements of this revision was the almost complete harmonization of balance of payments concepts and measures with the relevant *SNA* concepts and measures. In this regard, the *Manual on Government Finance Statistics* is being revised and a new *Manual on Monetary and Financial Statistics* is being developed. In both cases, harmonization with the new *SNA* is a major guiding principle. When this work is completed, compilers and users of the major systems of macroeconomic statistics will benefit from greater harmonization and integration. ■

Kevin W. O'Connor,
IMF Statistics Department

Accounts of the 1993 *SNA* and Major Balancing Items and Aggregates

Accounts	Balancing Items and Aggregates
Current	
Production	Gross Domestic Product (GDP) for the economy and gross value added for the sectors; Net Domestic Product (NDP) and net value added[1]
Generation and allocation of income	Compensation of employees, taxes less subsidies on production and imports, operating surplus, interest and dividends, Gross National Income (GNI)[1]
Distribution of income	Taxes on income and wealth, current transfers, Gross Disposable Income (GDI)[1]
Use of income	Consumption, saving, current external balance
Accumulation	
Capital account	Gross fixed capital formation, capital transfers, change in inventories, valuable net lending or borrowing
Financial account	Net acquisition of financial assets, net incurrence of liabilities
Other changes in volume of assets	Catastrophic losses, uncompensated seizures, economic appearance and disappearance of assets, changes in net worth due to these factors
Revaluation account	Holding (capital) gains and losses, changes in net worth owing to holding gains and losses
Balance Sheets	
Opening balance sheet	Nonfinancial assets, financial assets, liabilities, and net worth
Changes in balance sheet	Changes in net worth reflected in accumulation accounts
Closing balance sheet	Nonfinancial assets, financial assets, liabilities, and net worth

[1]For most "gross" measures in the *SNA*, there is a corresponding "net" measure. In all cases, the difference between gross and net is consumption of fixed capital.

The English version of the 1993 *SNA* is available now; versions in Arabic, Chinese, French, Russian, and Spanish are being prepared. Copies in English are available for $85.00 from Publication Services, IMF, Washington, D.C. 20431, U.S.A. (Telephone (202) 623-7430, Telefax (202) 623-7201.)

From the Executive Board . . .

Macedonia: Systemic Transformation Facility. The IMF has approved a credit totaling SDR 12.4 million (about $17 million) for the former Yugoslav Republic of Macedonia (FYRM) under the systemic transformation facility (STF) to support the Government's economic program for 1994.

The economic performance of the FYRM has deteriorated significantly since independence as inflation accelerated to levels verging on hyperinflation. A further drop in output brought economic activity to about half of its 1989 level, and unemployment rose to 28 percent. While, in part, these imbalances had their origin in the regional crisis, they were compounded by the deep-seated structural weaknesses in the labor and financial markets of the FYRM, and by a weak balance of payments position.

The Government's main objective for 1994 is to reduce the rate of monthly inflation to 2 percent by year-end, as a precursor to comprehensive structural reform. The program's anti-inflationary thrust relies on wage controls, tightening of monetary policy, and stricter budgetary discipline. In order to halt the growth in public sector arrears and continue to avoid public sector recourse to the banking system, the 1994 budget and accompanying laws entail a significant tightening of fiscal policies. The general government budget deficit will be limited to 6.6 percent of gross social product (GSP) in 1994, compared with 10.9 percent of GSP in 1993. To support and sustain the stabilization efforts, the authorities will launch—as part of their structural reform program—a comprehensive bank rehabilitation program in cooperation with the World Bank. Moreover, a large number of enterprises are in the process of preparing privatization programs. In order to unlock much-needed external assistance, the FYRM will seek an early normalization of relations with external creditors. As a first step, arrears to the World Bank have been cleared. The balance of payments outlook for 1994 remains uncertain, however, unless an easing of the regional conflict permits renewed use of traditional transshipment routes and partial restoration of access to former markets. The IMF's support under the STF will help strengthen of the FYRM's weak international reserve position during the program period.

The FYRM succeeded to membership in the IMF of the former Socialist Federal Republic of Yugoslavia, effective December 14, 1992. The FYRM's quota is SDR 49.6 million (about $68 million), and its outstanding financial obligations to the IMF total SDR 2.8 million (about $3.85 million).

Press Release No. 94/4, February 14

Zimbabwe: Enhanced Structural Adjustment Facility. The IMF has approved the use of its financial resources by Zimbabwe, totaling the equivalent of SDR 105.0 million (about $144 million), in support of the Government's economic and financial program for 1993/94. Of this total, SDR 66.8 million (about $92 million) is the second annual loan under the three-year enhanced structural adjustment facility (ESAF), of which SDR 33.4 million (about $46 million) may be disbursed immediately. An additional SDR 38.2 million (about $52 million) is available under the second annual program under the extended Fund facility (EFF), of which half (about $26 million) may be drawn immediately. The parallel arrangements for Zimbabwe under the ESAF and EFF, equivalent to SDR 315.2 million (about $433 million), were approved on September 11, 1992.

During the 1992/93 program, Zimbabwe's economic performance was adversely affected by the drought that hit southern Africa. Despite a significant recovery in agricultural output, continued weakness in manufacturing and other domestic production is expected to limit real GDP growth to a maximum of 2 percent in 1993. However, there was considerable progress in containing inflation, which slowed to 19 percent in 1993. The budget deficit increased to 11.2 percent of GDP, due largely to overruns on drought-relief expenditure and larger-than-expected wage, interest, and transfer payments. Stagnant export receipts, a contraction of imports, and a weaker capital account surplus dominated developments in the balance of payments in 1993, when the external current account deficit (excluding official transfers) fell more sharply than expected to 5 percent of GDP.

Zimbabwe's economic program for 1993/94 aims at achieving real GDP growth of 4–5 percent; reducing the rate of inflation to about 13 percent by end-1994; limiting the current account deficit to about 7 percent of GDP in 1994; and maintaining gross international reserves at no less than four months of import cover. To these ends, fiscal policy will aim at a substantial reduction in the overall central government budget deficit to 5 percent of GDP in the program year through several revenue-enhancing and expenditure-reducing measures and through a considerable improvement in fiscal management. Monetary policy will continue to be restrained.

In the area of structural reform, the authorities adopted measures to facilitate foreign investment in Zimbabwe, to strengthen the reform of public enterprises, and to further liberalize the exchange and trade system. On January 1, 1994, the export retention scheme, providing entitlement to foreign exchange, was transformed into a system where foreign exchange itself is retained and traded in an interbank market at market-determined exchange rates. With the introduction of the retention of export proceeds in foreign currency accounts, the retention rate was increased from 50 percent to 60 percent. Concurrently, the authorities liberalized current external payments for imports and a range of services.

Zimbabwe joined the IMF on September 29, 1980. Its quota is SDR 261.30 million (about $359 million), and its outstanding financial obligations to the IMF currently total the equivalent of SDR 205.0 million (about $282 million).

Press Release No. 94/5, February 14

SDR Rates

Week Beginning	Interest and Charges (percent)
Feb. 14	3.99
Feb. 21	3.98

The rate of SDR interest and charges is calculated weekly, by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rates call (202) 623-7171.

Data: IMF Treasurer's Department

Nepal's Reform Strategy Emphasizes Investment

Nepal is taking practical steps to strengthen its economic growth and raise its living standards in a market-oriented environment. The goal of the Government—elected in May 1991 as Nepal's first parliamentary democracy—is to achieve sustainable growth through economic liberalization and comprehensive structural reform. To support the Government's medium-term adjustment and reform efforts, the IMF approved an arrangement under the enhanced structural adjustment facility (ESAF) in the amount of SDR 33.57 million (about $49 million) in October 1992. The Nepalese reforms are the subject of a newly published study of Nepal, in the IMF's Economic Review series.

Macroeconomic Issues

The study examines several macroeconomic issues that have important policy implications.

Demand for Money. The authors conclude that the demand for money in Nepal is volatile and has a high income elasticity. This reflects the fact that monetization is still ongoing as the country continues to develop. Monetary policy will need to be formulated flexibly while structural reforms—in particular, financial liberalization—are being implemented, and it will have to take into account conditions in neighboring countries.

Price Behavior. The Economic Review compares price behavior in Nepal with that in India and finds the two closely linked. Indeed, movements in the two countries' exchange rates are quickly reflected in price changes, with little lasting effect on the bilateral real exchange rate. One implication is that the effectiveness of Nepal's monetary or credit policy will be reflected not in price developments but rather in the balance of payments.

Choice of Exchange Rate Regime. The close relationship between prices in Nepal and India has important implications for Nepal's choice of exchange rate regime. The authors examine the considerations involved in this choice, taking into account the adoption of a more outward-looking economic strategy in Nepal and increased trade, together with overall trade and exchange liberalization that has been matched by reforms in India. They conclude that the current exchange rate regime—a de facto peg to the Indian rupee—continues to have advantages because it allows Nepal to capitalize on its proximity to the large neighboring market.

Reform Strategy

Nepal's economic reform strategy has two main planks:

- to improve the quality of public investment through more efficient use of foreign aid in projects yielding a high return; and
- to encourage private sector activity by promoting macroeconomic stability and enhancing incentives for private investment through industrial delicensing, streamlining the tax system, privatizing public enterprises, and simplifying the trade and exchange system.

Public Sector Reforms

Development Budget Reforms. Development budget reforms are aimed at increasing the efficiency of Nepal's fiscal expenditure, two thirds of which is committed to development. The stated goal of Nepal's development spending is to raise future living standards and strengthen the social and physical infrastructure. Projects are concentrated in three areas: the social sector, agriculture, and industry and infrastructure, with the latter two becoming less important as the private sector takes over.

Hydroelectric Project. Demand for electricity in Nepal has risen sharply and new sources of supply are thus needed. Feasibility studies concluded that the best solution would be a major hydroelectric project in the Arun River valley; a $750 million project—about one fourth of Nepal's annual GDP—will be implemented over the next decade. Efforts are also under way to bolster electricity supply in the interim.

Public Enterprise Reform. A complete overhaul of the public enterprise sector is under way. Most public enterprises in Nepal will be privatized, while those remaining will have to increase their commercial orientation. There has been only limited success so far with enhancing the commercial orientation of the financial public enterprises (state banks account for three fourths of deposits), an outcome that has perpetuated large deposit-lending interest rate spreads.

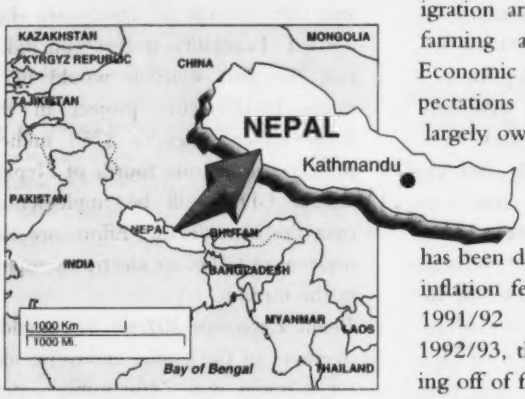
Civil Service Reform. The Government views increased efficiency of the civil service as essential if Nepal is to achieve its development objectives and maintain popular support for public programs. Accordingly, cuts have been made in the size of the civil service, and quality is to be improved through increased pay, more discriminating hiring practices, enhanced training opportunities, and delegation from the central government level to district and local levels.

Tax Reform

The tax system is being reformed to raise additional revenue and to make it more equitable and efficient. Trade

Nepal: A Brief Profile

Nepal, a landlocked country in the central Himalayas and the adjoining Ganges plain, enjoys a close relationship with its neighboring countries. There is free movement of goods, labor, and services between Nepal and India. The mountains and hills in the north give the country considerable tourism and hydroelectric potential, while half of the southern plains are agriculturally cultivated. Population growth (currently about 2½ percent a year) and rural emigration are contributing to overfarming and urban congestion. Economic growth fell short of expectations in the early 1990s, largely owing to insufficient monsoon rainfalls, which cut agricultural output. Non-agricultural output has been doing well, however, and inflation fell from double digits in 1991/92 to single digits in 1992/93, thanks mainly to a leveling off of food prices.



reform has reduced revenues from taxes on trade, and an expected rise in revenue from domestic sources has been slower than planned. The 1993/94 budget, announced in July 1993, included ambitious measures to address structural problems in the tax system.

Trade and Exchange Rate Reform

Perhaps the authorities' greatest success has been in reforming the trade and exchange system, which had been highly distorted and inward-looking and is now relatively transparent. The following steps were taken:

- import tariffs were cut;
- the import license auction was abolished;
- export incentives were improved; and
- the dual exchange rate was unified.

These steps have facilitated a marked expansion in trade, especially with countries other than India, and the balance of payments has strengthened substantially despite shortfalls in foreign aid. The increase in exports—especially carpets and garments—has contributed significantly to Nepal's economic growth and its improved external position. The improvement in growth and increased interest of private investors and public donors have instilled confidence in the Nepalese economy, which in turn has allowed the pace of reform to accelerate. ■

Nepal, by Owen Evans, Nancy Benjamin, Robert Kahn, Christian Mulder, Karen Parker, Ronald Pearson, and Jodi Scarlata, is part of the IMF's Economic Review series. Nepal is the first country outside the former Soviet Union to be featured in this series. Copies of the Economic Reviews are available for $15.00 each from Publication Services, Box S-391, International Monetary Fund, Washington, DC 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

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